Part F. Tax Abuses--Income Shifting

Although the proposed rate schedule for individuals is flatter than under current law, there would remain a substantial difference between the top rate and bottom rate. Thus, as under current law, taxpayers subject to the top rate would have an incentive to shift income to their children or other family members subject to tax at lower rates. Current law limits income shifting through various rules, including the assignment-of-income doctrine and the interest-free loan provisions. This Part discusses proposed rules that would butress current limits on income-shifting by preventing taxpayers from reducing the tax on unearned income by transferring income to minor children or establishing trusts.

ADJUST TAX RATE OF UNEARNED INCOME OF MINOR CHILDREN

General Explanation

Chapter 3.24

Current Law

Minor children generally are subject to the same income tax rules as adults. If a child is claimed as a dependent on another taxpayer's return, however, the zero bracket amount is limited to the amount of the child's earned income. Accordingly, the child must pay tax on any unearned income in excess of the personal exemption ($1,040 in 1985).

Under current law, when parents or other persons transfer investment assets to a child, the income from such assets generally is taxed thereafter to the child, even if the transferor retains significant control over the assets. For example, under the Uniform Gifts to Minors Act (UGMA), a person may give stock, a security (such as a bond), a life insurance policy, an annuity contract, or money to a custodian for the child (who generally may be the donor). As a result of the gift, legal title to the property is vested indefeasibly in the child. During the child's minority, however, the custodian has the power to sell and reinvest the property; to pay over amounts for the support, maintenance, and benefit of the minor; or to accumulate income in the custodian's discretion.

Results similar to that achieved by a transfer under UGMA may be obtained by transferring property to a trust or to a court-appointed guardian. Parents also may shift income-producing assets to their children, without relinquishing control over the assets, by contributing such assets to a partnership or S corporation and giving the children partnership interests or shares of stock.

Reasons for Change

Under current law, a family may reduce its aggregate tax liability by splitting assets among family members. So-called income splitting is a common tax-planning technique. Parents frequently tranfser assets to their children so that a portion of the family income will be taxed at the child's lower marginal tax rate.

Income splitting undermines the progressive rate structure and is a source of unfairness in the tax system. It increases the relative tax burden of taxpayers who are unable to use this device, either because they do not have significant investment assets or do not have children.

The ability to shift investment income to children under current law is primarily of benefit to wealthy taxpayers. A family whose income consists largely of wages earned by one or both parents pays

tax on that income at the marginal rate of the parents. Even though the income is used in part for the living expenses of the children, parents may not allocate a portion of their salary to their children and have it taxed at the children's lower tax rates. Moreover, parents with modest savings may not be able to afford to transfer such savings to their children; thus, such families must pay tax on the income from their savings at the parents' marginal tax rate. Families with larger amounts of capital, however, can afford to transfer some of it to the children, thereby shifting the income to lower tax brackets. Use of a trust or a gift under UGMA allows the parents to achieve this result without relinquishing control over the property until the children come of age.

Proposal

Unearned income of children under 14 years of age that is attributable to property received from their parents would be taxed at the marginal tax rate of their parents. This rule would apply only to the extent that the child's unearned income exceeded the personal exemption ($2,000 under the Treasury Department proposals). The child's tax liability on such unearned income would be equal to the additional tax that his or her parents would owe if such income were added to the parents' taxable income and reported on their return. If the parents reported a net loss on their return, the child's tax liability would be computed as if his or her parents' taxable income was zero. If more than one child has unearned income which is taxable at the parents' rate, such income would be aggregated and added to the parents' taxable income. Each child would then be liable for a proportionate part of the incremental tax.

All unearned income of a child would be treated as attributable to property received from a parent, unless the income was derived from a qualified segregated account. A child who receives money or property from someone other than a parent, such as another relative, or who earns income, could place such property or earnings into a qualified segregated account. No amount received directly or indirectly from a parent could be placed into such an account.

For purposes of this provision, an adopted child's parents would be the adoptive parent or parents. In the case of a foster child, the parents would be either the natural parents or the foster parents, at the child's election. If the parents are married and file a joint return, the child's tax would be computed with reference to the parents' joint income. If the parents live together as of the close of the taxable year, but do not file a joint return (i.e., file separate returns if married or file as single individuals), then the child's tax would be computed with reference to the income of the parent with the higher taxable income. If the parents do not file a joint return and are not living together as of the close of the taxable year, the child's tax would be computed with reference to the income of the parent having custody of the child for the greater portion of the taxable year.

Expenses that are properly attributable to the child's unearned income would be allowed as deductions against such income. Itemized deductions generally would be allocated between earned and unearned income in any manner chosen by the taxpayer. Interest expense, however, would be deductible against unearned income that is taxable at the parents' tax rate only if it was attributable to debt that was assumed by the child in connection with a transfer of property from the parents, or to debt that encumbered such property at the time of the transfer.

The personal exemption would be used first against income from a qualified segregated account and then against other unearned income. Thus, such income would not be taxable unless the child's total unearned income was greater than the personal exemption. Earned income and income from a qualified segregated account in excess of the personal exemption would be taxable (after subtracting the zero bracket amount or itemized deductions) under the rate schedule applicable to single individuals, starting at the lowest rate. (Unlike current law, the zero bracket amount could be used against both the child's earned income and unearned income from a segregated account.)

The proposed taxation of income of children under 14 years of age may be illustrated by the following example. Assume that a child had $3,000 of income from a qualified segregated account, other unearned income of $2,000, and earned income of $500. The personal exemption ($2,000) would be used against the qualified segregated account income, leaving $1,000 of such income plus $500 of earned income subject to tax at the child's rate. No tax on this $1,500 would be due, since it would be less than the zero bracket amount. The $2,000 unearned income would be subject to tax at the parents' rate. If the child had itemized deductions, they could be used against either this $2,000 or against the $1,500 taxable at the child's rate.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would help to ensure the integrity of the progressive tax rate structure, which is designed to impose tax burdens in accordance with each taxpayer's ability to pay. Families would be taxed at the rate applicable to the total earned and unearned income of the parents, including income from property that the parents transferred to the children's names. The current tax incentive for transferring investment property to minor children would be eliminated.

Under the proposal, the unearned income of a minor child under 14 years of age would be taxed at his or her parent's rate. This is the age at which children may work in certain employment under the Fair

Labor Standards Act. In addition, in most cases the income tax return of a child under 14 years of age is prepared by or on behalf of the parent and signed by the parent as guardian of the child. Thus, in most cases, the requirement that a child's income be aggregated with that of his or her parents would not create a problem of confidentiality with respect to the parents' return information, since there would be no need to divulge this information to the child.

Only children required to file a return under current law would be required to do so under the proposal. In 1981, only 612,000 persons who filed returns reporting unearned income were claimed as dependents on another taxpayer's return. This represents less than one percent of the number of children claimed as dependents in that year. Although the return would generally be filed by a parent on behalf of a child, liability for the tax would rest, as under current law, on the child.

REVISE GRANTOR AND NON-GRANTOR TRUST TAXATION

General Explanation

Chapter 3.25

Current Law

In General

The manner in which the income from property held in trust is taxed depends upon the extent to which the grantor has retained an interest in the trust. A so-called "grantor trust," a trust in which the grantor has retained a proscribed interest, is treated as owned by the grantor and the trust's income is taxable directly to the grantor. Non-grantor trusts, including "Clifford trusts," on the other hand, are treated as separate taxpayers for Federal income tax purposes, with trust income subject to a separate graduated rate structure.

The rules for determining whether a trust will be treated as a grantor trust are highly complex. In general, however, the test is whether the grantor has retained an interest in the trust's assets or income or is able to exercise certain administrative powers. For example, to the extent that the grantor (or a party whose interests are not adverse to the grantor) has the right to vest the trust's income or assets in the grantor, the trust will be treated as a grantor trust. Similarly, to the extent that the trust's assets or income may reasonably be expected to revert to the grantor within ten years of the trust's creation, the trust will generally be treated as a grantor trust.

In general, the income of a non-grantor trust is subject to one level of tax; it is taxable either to the trust itself or to the beneficiaries of the trust. Under this general model, trust income is included as gross income of the trust, but distributions of such income to trust beneficiaries are deductible by the trust and includible in the income of the beneficiaries.

The maximum distribution deduction permitted to a trust, and the maximum amount includible in the income of trust beneficiaries, is the trust's "distributable net income" (DNI). A trust's DNI consists of its taxable income computed with certain modifications, the most significant of which are the subtraction of most capital gain and the addition of any tax-exempt income earned by the trust.

To the extent that a trust distribution carries out DNI to a beneficiary, the trust essentially serves as a conduit, with the beneficiary taking into account separately his or her share of each trust item included in DNI. Under a complex set of rules, the computation of each beneficiary's share of an item of trust income generally depends upon the amount distributed to the beneficiary and the "tier" to which the beneficiary belongs. A distribution that does

not carry out DNI -- such as one in satisfaction of a gift or bequest of specific property or a specific sum of money, or one in excess of DNI -- is not deductible by the trust and is not includible in the recipient's income. Similarly, because capital gains generally are excluded from the computation of DNI, a trust ordinarily is subject to taxation on the entire amount of its capital gain income even when it distributes an amount in excess of its DNI.

Adoption of Taxable Year

The trustee of a non-grantor trust may select a year ending on the last day of any month as the trust's taxable year. Although a trust distribution that carries out DNI is generally deductible by the trust in the taxable year during which it is made, the distribution is not taxable to the beneficiary until his or her taxable year with which or in which the trust's taxable year ends. Thus, for example, if an individual is a calendar-year taxpayer and is the beneficiary of a trust with a taxable year ending January 31, distributions made by the trust with respect to its year ending January 31, 1984, will not be subject to tax until the beneficiary's year ending December 31, 1984, even if they were made as early as February 1983.

Throwback Rules

The so-called "throwback rules" are applicable only to trusts that accumulate income rather than distribute it currently to the beneficiaries. These rules limit the use of a trust as a device to accumulate income at a marginal tax rate lower than that of the beneficiaries. DNI that is accumulated rather than distributed currently becomes undistributed net income (UNI) and may be subject to additional tax when distributed to the beneficiaries.

The rules for determining the amount, if any, of such additional tax are complex. In general, however, if a trust's current distributions exceed its DNI and the trust has UNI from prior taxable years, the excess distributions (to the extent of UNI) will be taxed at the beneficiary's average marginal tax rate over a specified period preceding the distribution as reduced by a credit for the tax paid by the trust on such UNI.

Reasons for Change

Taxpayer Fairness

The treatment of trusts as separate taxpayers with a separate graduated rate structure is inconsistent with a basic principle of the tax system that all income of an individual taxpayer should be subject to tax under the same progressive rate structure. The primary purposes of a trust are to manage investment assets and to allocate the income from those assets to beneficiaries. If trust income is to be taxed at a rate that is consistent with the purpose of the progressive rate structure, it should be taxed currently to those who have control over or receive the benefit of the trust's income. Where

the grantor may reasonably be considered to have retained control or enjoyment of the trust, the trust's income is included appropriately in the grantor's income or taxed at the grantor's marginal tax rate; where the grantor has effectively divested himself of control and enjoyment, the income should be taxed to the beneficial owners of the trust. There is no persuasive justification for taxing a trust under its own graduated rate structure. The lowest marginal tax rate is designed to protect low-income individuals from paying an undue percentage of their income as tax. Although this rationale applies to individual trust beneficiaries, it does not apply to trusts as separate entities.

Although the throwback rules are designed to prevent income splitting between trusts and beneficiaries in order to take advantage of trusts' separate rate structure, these rules often do not recapture the tax savings from the accumulation of income inside the trust. The throwback formula, for example, often does not properly reflect whether the beneficiary's tax rate declined between the time of accumulation and distribution. In addition, the throwback rules do not take into account the benefit of the deferral of tax during the period between the income accumulation and the taxation of an accumulation distribution. Finally, the throwback rules are wholly inapplicable to income accumulated while the beneficiary is under 21 years of age as well as to retained capital gain income.

Present law also permits a grantor to shift income to family members through creation of a trust, even when the grantor retains significant control over or a beneficial interest in the trust's assets. For example, trust income will not be taxed to the grantor even though the trust's assets will revert to the grantor as soon as ten years after the trust's creation. Similarly, trust income will not be taxed to the grantor even though the grantor appoints himself or herself as trustee with certain discretionary powers to accumulate income or distribute trust assets. Significantly broader discretion over trust income and distributions may be vested in an independent trustee, who, though not formally subject to the grantor's control, may be expected to exercise his or her discretion in a manner that minimizes the aggregate tax burden of the trust's grantor and beneficiaries.

Efficiency and Simplification

The significant income-splitting advantages that may be gained by placing income-producing assets in trust have resulted in greater utilization of the trust device than would be justified by non-tax economic considerations. Moreover, even where there are non-tax reasons for a trust's creation, tax considerations heavily influence the trustee's determination of whether to accumulate or distribute trust income. No discernable social policy is served by this tax incentive for the creation of trusts and the accumulation of income within them. Thus, current tax policy has not only sacrificed tax

revenue with respect to trust income, it also has encouraged artificial and inefficient arrangements for the ownership and management of property.

The tax advantages that current law provides to trusts also have spawned a complex array of anti-abuse provisions. The grantor trust rules and the throwback rules are highly complex and often arbitrary in their application. Rules that attribute capital gain of certain non-grantor trusts to the grantor are also complex in operation and can have unforeseen consequences to trust grantors. In addition, the fact that the tax benefits of the trust form can be increased through the creation of multiple trusts has resulted in the creation of numerous trusts with essentially similar dispositive provisions. This "multiple trust" problem has necessitated a statutory response that would be unnecessary if the tax benefits of creating trusts could be minimized.

Proposal

Taxation of Trusts During Lifetime of Grantor

1. Overview

During the lifetime of the grantor, all trusts created by the grantor would be divided into two categories: trusts that are treated as owned by the grantor for Federal income tax purposes, because the grantor has retained a present interest in or control over the trust property; and trusts that are not treated as owned by the grantor, because the grantor does not have any present interest in or control over the property. As under current law, the income of a trust classified as a grantor-owned trust generally would be taxed directly to the grantor to the extent that the grantor is treated as the owner. A non-grantor-owned trust generally would be respected as a separate taxable entity. During the grantor's lifetime, however, income would be taxed to the trust at the grantor's marginal tax rate, unless the trust instrument requires the distribution of income to specified beneficiaries.

2. Grantor-owned trusts

The grantor would be treated as the owner of a trust to the extent that (i) payments of property or income are required to be made currently to the grantor or the grantor's spouse; (ii) payments of property or income may be made currently to the grantor or the grantor's spouse under a discretionary power held in whole or in part by either one of them; (iii) the grantor or the grantor's spouse has any power to amend or to revoke the trust and cause distributions of property to be made to either one of them; (iv) the grantor or the grantor's spouse has any power to cause the trustee to lend trust income or corpus to either of them; or (v) the grantor or the grantor's spouse has borrowed trust income or corpus and has not completely repaid the loan or any interest thereon before the beginning of the taxable year. For purposes of these rules, the fact

that a power held by the grantor or the grantor's spouse could be exercised only with the consent of another person or persons would be irrelevant, regardless of whether such person or persons would be characterized as "adverse parties" under present law.

The present law rules under which a person other than the grantor may be treated as owner of a trust would be retained and made consistent with these rules. A grantor or other person who is treated as the owner of any portion of a trust under these rules would be subject to tax on the income of such portion. Transactions between the trust and its owner would be disregarded for Federal income tax purposes where appropriate.

3. Non-grantor-owned trusts

(a) In general. A trust that is not treated as owned by the grantor or by any other person under the rules described above would be subject to tax as a separate entity. Unlike present law, however, non-grantor-owned trusts would be required to adopt the same taxable year as the grantor, thereby limiting the use of fiscal years by trusts to defer the taxation of trust income.

The trust would compute its taxable income in the same manner as an individual, but would not be entitled to a zero bracket amount or a personal exemption (or deduction in lieu of a personal exemption). The trust would be entitled to a deduction for charitable contributions, but only to the extent that the grantor would have received a deduction if the grantor were the owner of the entire trust. Thus, if the grantor's charitable contributions were less than two percent of his or her adjusted gross income, the trust would receive a charitable contribution deduction only to the extent that its contributions exceed the sum of the (i) grantor's unused charitable deduction floor and (ii) two percent of the trust's adjusted gross income. See Ch. 3.18. In order to be deductible, a charitable contribution would have to be made within 65 days of the close of the trust's taxable year.

(b) Distribution deduction. The present rules regarding the deductibility of distributions made by a trust to non-charitable beneficiaries would be substantially changed. First, during the lifetime of the grantor, only mandatory distributions would be deductible by a trust. A distribution would qualify for this deduction only if a fixed or ascertainable amount of trust income or property is required to be distributed to a specific beneficiary or beneficiaries. As under present law, distributions required to be made would be deductible regardless of whether actually made by the trustee.

The amount of a mandatory distribution would be considered fixed or ascertainable if expressed in the governing instrument as a portion or percentage of trust income. The requirement that each beneficiary's share be fixed or ascertainable also would be satisfied by a requirement that distributions be made on a per capita or per

stirpital basis that does not give any person the right to vary the beneficiaries' proportionate interests. Thus, distributions would not qualify as mandatory if the governing instrument requires the distribution of all income among a class of beneficiaries, but gives any person the right to vary the proportionate interests of the members of the class in trust income.

A distribution would be considered mandatory if required upon the happening of an event not within the control of the grantor, the grantor's spouse, or the trustee, such as the marriage of a beneficiary or the exercise by an adult beneficiary of an unrestricted power of withdrawal. The requirement that the governing instrument specify the beneficiary or beneficiaries of a mandatory distribution would be satisfied if a class of beneficiaries were specified and particular beneficiaries could be added or removed only upon the happening of certain events not within the control of the grantor, grantor's spouse, or trustee, such as the birth or adoption of a child, marriage, divorce, or attainment of a certain age.

Second, unlike present law, property required to be irrevocably set aside for a beneficiary would be treated as a mandatory distribution, provided the amount set aside is required to be distributed ultimately to the beneficiary or the beneficiary's estate, or is subject to a power exercisable by the beneficiary the possession of which will cause the property to be included in the beneficiary's estate for Federal estate tax purposes. Thus, the trustee could designate property as irrevocably set aside for a beneficiary and obtain a distribution deduction (provided that a distribution or set-aside is mandatory under the governing instrument) without making an actual distribution to the beneficiary.

If the tax imposed on a beneficiary by reason of a set-aside exceeds the amount actually distributed to the beneficiary in any year, the beneficiary could be permitted under the governing instrument to obtain a contribution from the trustee equal to the tax liability imposed by reason of the set-aside (less any amounts previously distributed to the beneficiary during the taxable year). Such contribution would be paid out of the amount set aside, and therefore would not carry out additional DNI. This structure, unlike present law, would permit a fiduciary to obtain the benefit of a beneficiary's lower tax bracket through an irrevocable set-aside. Accordingly, tax motivations would not override non-tax factors which might indicate that an actual distribution is undesirable.

Third, whether mandatory or not, distributions to non-charitable beneficiaries would not be deductible during the lifetime of the grantor under the following circumstances indicating incomplete relinquishment of interest in or dominion and control over the trust:

(i) If any person has the discretionary power to make distributions of corpus or income to the grantor or the grantor's spouse;

(ii) If any portion of the trust may revert to the grantor or the grantor's spouse, unless the reversion cannot occur prior to the death of the income beneficiary of such portion and such beneficiary is younger than the grantor, or prior to the expiration of a term of years that is greater than the life expectancy of the grantor at the creation or the funding of the trust;

(iii) If any person has the power exercisable in a non-fiduciary capacity to control trust investments, to deal with the trust for less than full and adequate consideration, or to exercise any general administrative powers in a non-fiduciary capacity without the consent of a fiduciary;

(iv) If and to the extent that an otherwise deductible mandatory distribution satisfies a legal obligation of the grantor or grantor's spouse, including a legal obligation of support or maintenance; or

(v) If trust income or corpus can be used to carry premiums on life insurance policies on the life of the grantor or the grantor's spouse with respect to which the grantor or the grantor's spouse possesses any incident of ownership.

(c) Computation of tax liability. Once the taxable income of an inter vivos trust has been computed under the rules described above, the trust's tax liability would be determined. This liability would be the excess of (i) the tax liability that would have been imposed on the grantor had the trust's taxable income been added to the greater of zero or the grantor's taxable income and reported on the grantor's return, over (ii) the tax liability that is actually imposed on the grantor. Thus, the trust's tax liability generally would equal the incremental amount of tax that the grantor would have paid had the trust been classified as a grantor trust, with two exceptions. First, to avoid the difficulty associated with any recomputation of a grantor's net operating loss carryover and other complexities, if the grantor has incurred a loss in the taxable year or in a prior taxable year, such loss would be disregarded and the grantor would be deemed to have a taxable income of zero for purposes of computing the trust's tax liability. Second, the addition of the trust's taxable income to the taxable income of the grantor would not affect the computation of the grantor's taxable income. For example, trust income would not be attributed to the grantor for purposes of determining the grantor's floor on various deductions. See Ch. 3.18 and Ch. 4.03.

If the grantor has created more than one non-grantor trust, then each such trust would be liable for a proportionate share of the tax that would result from adding their aggregate taxable income to the greater of zero or the grantor's taxable income. If one or more trusts do not cooperate with the grantor and other trusts in determining their tax liability under these rules, the trusts failing to cooperate would be subject to the highest marginal rate applicable to individuals and would be ineligible for the charitable contribution

deduction. Similarly, if the grantor does not provide a trustee with information sufficient to enable the trustee to compute the trust's tax liability under these rules, the trustee would be required to assume (for purposes of computing the trust's tax) that the grantor had taxable income placing him or her in the highest marginal rate and had an unused charitable deduction floor that exceeds the trust's charitable contributions.

(d) Taxation of beneficiaries. As under current law, distributions to beneficiaries that are deductible by a trust would be taxable to the beneficiaries, with the trust's DNI representing the maximum amount deductible by the trust and includible in the income of the beneficiaries. Capital gain deemed to be distributed would be included in the computation of the trust's DNI. Capital gain income would be deemed to be distributed if the trust instrument requires that it be distributed or if and to the extent that mandatory distributions and set-asides exceed DNI (as computed without regard to such gain). Each recipient of a required distribution or set-aside would take into account his or her proportionate share of DNI. Thus, the tier rules of present law would be eliminated. Each item entering the computation of DNI, including capital gains that are deemed to be distributed and hence are included in DNI, would be allocated among the beneficiaries and the trust, based on the proportionate amounts distributed to or set aside for each beneficiary.

(e) Multiple grantors. For purposes of determining whether the grantor is the owner of any portion of a trust, and for purposes of determining whether a mandatory distribution is deductible, if there is more than one grantor, a trust would be treated as consisting of separate trusts with respect to each grantor. If a husband and wife are both grantors with respect to a trust, however, they would be entitled to elect one of them to be treated as the grantor with respect to the entire trust. Once made, such an election would be irrevocable and would apply to all subsequent transfers made during the course of the marriage by either spouse.

Taxation of Trusts After Death of Grantor

For all taxable years beginning after the death of an individual, all inter vivos and testamentary trusts established by such individual would compute their taxable income as in the case of an individual, but with no zero bracket amount, no personal exemption (or deduction in lieu of a personal exemption), and with a distribution deduction for all distributions or set-asides required to be made and for all distributions and set-asides, whether mandatory or discretionary, actually made to or for non-charitable beneficiaries. As under present law, distributions made within 65 days of the close of the taxable year would be treated as made on the last day of the taxable year. A similar rule would apply to set-asides. Charitable contributions would be fully deductible to the extent that they exceed two percent of the trust's adjusted gross income. All trusts would

compute DNI in the same manner as non-grantor trusts. Any taxable income of the trust would be subject to tax at the highest individual marginal rate.

For the taxable year in which the grantor's death occurs, a grantor-owned trust would close a short taxable year ending with the date of the grantor's death, and its income for such period would be taxed to the grantor as under present law. For the remainder of the taxable year, the trust would compute its taxable income with a distribution deduction computed under the post-death rules. Rather than being subject to tax at the highest marginal rate, however, the trust would compute its tax liability for this short taxable period by adding its taxable income to the taxable income of the grantor for the grantor's final taxable year.

For the period ending with the death of the grantor, a non-grantor-owned inter vivos trust would compute taxable income in the same manner as before the death of the grantor. Accordingly, such a trust would be entitled to a deduction for qualifying distributions to charity and for all mandatory distributions or set-asides with respect to non-charitable beneficiaries. The trust's taxable year would not terminate with the death of the grantor, but the trust would be entitled to a distribution deduction under the post-death rules for all distributions or set-asides made after the grantor's death. As with taxable years ending before the grantor's death, the trust would compute its tax liability for the grantor's final year by reference to the taxable income of the grantor.

Testamentary trusts would compute their income using the same taxable year as the decedent and the decedent's estate. A testamentary trust created before the end of the taxable year of the decedent's death would compute its tax liability for its first (short) taxable year along with all other trusts created by the decedent, by reference to the decedent's taxable income for that year.

Effective Date

The proposal would apply generally to irrevocable trusts created after the date that legislation containing the proposal is introduced and to trusts that are revocable on the date that the legislation is introduced, for taxable years beginning on or after January 1, 1986. A trust that is irrevocable on the date that the legislation is introduced would nevertheless be treated as created after the date that the legislation is introduced if any amount is transferred to such trust after such date. Similarly, a trust that is revocable on the date that the legislation is introduced and that becomes irrevocable after such date would be treated as a new trust for purposes of these rules. A trust that is created after the date that legislation is introduced, but prior to January 1, 1986, would be required to adopt the taxable year of the grantor.

For trusts that are irrevocable on the date that the legislation is introduced, the proposal would apply according to the following rules. Trusts that are grantor trusts under present law would be subject to the new rules beginning with the first taxable year of the grantor that begins on or after January 1, 1986. If a trust that is classified as a grantor trust under present law is classified as a non-grantor trust under the new rules, however, it would be entitled to elect to be treated as if the grantor were the owner for Federal income tax purposes (such election to be made jointly by the grantor and the trustee).

With respect to trusts that are irrevocable on the date that the legislation is introduced and are not classified as grantor trusts under present law, the proposal would apply to taxable years beginning on or after January 1, 1986, with the following exceptions. First, if such a trust has already validly elected a fiscal year other than the grantor's taxable year on the date the legislation is introduced, the trust would be entitled to retain that year as its taxable year. In a case where the grantor and the trust have different taxable years, the trust would compute its tax liability by reference to the grantor's income for the grantor's taxable year ending within the taxable year of the trust. Second, such trusts would be entitled to a distribution deduction for all distributions and set-asides, whether discretionary or mandatory, made during the grantor's lifetime. Finally, such trusts would be entitled to elect to continue the tier system of present law for allocating DNI among trust beneficiaries.

With respect to income accumulated prior to the January 1, 1986, the throwback rules generally would be repealed. However, distributions out of previously accumulated income would be subject to tax in the hands of the beneficiary when distributed. Because the beneficiary's rate of tax may be significantly lower than under current law, the beneficiary would not be entitled to any credit for the taxes previously paid by the trust. The trust would be able to avoid application of this transitional throwback rule by a distribution or set-aside on the last day of the taxable year beginning prior to January 1, 1986, or by paying a tax at the trust level on UNI subject to the throwback rules based on the highest individual rate applicable under present law (with a credit for taxes previously paid by the trust).

Analysis

Because all trust income would be taxed to the grantor, taxed to trust beneficiaries, taxed to the trust at the grantor's marginal rate (during the grantor's lifetime), or taxed to the trust at the highest individual rate (after the grantor's death), the proposal would eliminate the use of trusts as an income-splitting device. In this respect, the proposal would reinforce the integrity of the progressive rate structure and thus enhance the fairness of the tax system.

The proposal would, in general, permit the use of non-grantor trusts to shift income among family members only if distributions or set-asides are mandatory and only if the grantor has effectively relinquished all rights in the trust property (other than the exercise of certain powers as trustee). In addition, present law would be liberalized in that amounts irrevocably set aside for a beneficiary would be treated as actually distributed. At the same time, wholly discretionary distributions would be ineffective to shift income to trust beneficiaries regardless of the identity of the trustee.

The proposal also would result in substantial simplification of the rules for taxation of trust income. The throwback rules, the tier system, and the special rule taxing some trust capital gain to the grantor would be repealed. In addition, the present grantor trust rules would be replaced by rules causing trusts to be taxed as grantor trusts or denying a distribution deduction in fairly limited circumstances. Requiring virtually all new trusts to use a calendar year would eliminate the artificial tax advantage often created by the selection of fiscal years. The simplicity created by these rules would more than offset whatever complexity is created by taxing inter vivos trusts at the grantor's marginal rate in certain circumstances.

The removal of the artificial tax advantages of trusts would cause decisions regarding the creation of trusts to be based on non-tax considerations. For example, because the income of a ten-year "Clifford" trust would be taxed at the grantor's marginal rate with no distribution deduction, such trusts would be created only where warranted by non-tax considerations. At the same time, however, the proposal would not impose a tax penalty on the use of a trust to hold and to manage a family's assets. At the worst, during the grantor's lifetime, trust income would be taxed as if the grantor had not established the trust. Although accumulated income would be taxed at the highest individual rate following the grantor's death, the deduction for set-asides as well as actual distributions would give the trustee ample flexibility to minimize the aggregate tax burden on trust income without making distributions.

REVISE INCOME TAXATION OF ESTATES

General Explanation

Chapter 3.26

Current Law

Under present law, a decedent's estate is recognized as a separate taxable entity for Federal income tax purposes. The separate existence of the estate begins with the death of the decedent, and the estate computes its income without regard to the decedent's taxable income for the period prior to the decedent's death. Because the estate's separate existence begins with the decedent's death, the estate is entitled to adopt its own taxable year without regard to the taxable year of the decedent or the taxable year of any beneficiary of the estate. Furthermore, any trust created by the decedent's will is entitled to select its own taxable year without regard to the year selected by the estate.

An estate generally computes its income in the same manner as an individual, with a $600 deduction allowed in lieu of the personal exemption. The amount of tax on an estate's income generally is determined in the same manner as a trust -- with a deduction allowed for distributions not in excess of distributable net income (DNI) -- except that the throwback rules applicable to trusts do not apply to estates. Thus, an estate can accumulate taxable income using its separate graduated rate structure and distribute the income in a later year free of any additional tax liability.

Under present law, the decedent's final return includes all items properly includible by the decedent in income for the period ending with the date of his death. All income received or accrued after the date of death is taxed to the estate rather than the decedent. The decedent's surviving spouse may elect, however, to file a joint Federal income tax return for the taxable year in which the decedent's death occurs.

Reasons for Change

Present law provides an incentive for the fiduciary of an estate to continue the period of administration for as long as possible in order to take advantage of the estate's separate graduated rate structure. Although current regulations provide for termination of an estate as a separate entity if the period of administration is unreasonably prolonged, the regulations are generally ineffective and seldom applied. Even where the period of administration is not unnecessarily extended, the inapplicability of the throwback rules to estates creates the likelihood that estate income will be subject to tax at a lower rate than the marginal tax bracket of the ultimate recipient.

The availability to an estate of a taxable year other than the calendar year creates tax avoidance opportunities. By appropriately timing distributions to beneficiaries of the estate, tax on income generated in the estate may be deferred for a full year. This deferral potential is exacerbated through the use of different fiscal years by testamentary trusts.

Estates can also use "trapping distributions" to allocate estate income among the maximum number of taxpayers and thereby minimize the aggregate tax burden imposed on estate income. The current rules for taxation of income during the taxable year in which the decedent dies create additional distortions. There is no necessary correlation between the timing of items of income and deduction and the date of death. Thus, for example, deductible expenses incurred prior to the date of death are not matched against income received after the date of death. This can result in the wasting of deductions on the decedent's final return or the stacking of income in the decedent's estate.

Proposal

The rules governing the taxation of estates would be changed so that the decedent's final taxable year would continue through the end of the taxable year in which his death occurs. Distributions by the decedent's personal representative to beneficiaries of the decedent's estate would not give rise to a distribution deduction against the decedent's income.

The first taxable year of the estate as a separate entity would be the first taxable year beginning after the decedent's death. The estate would be subject to tax at a separate rate schedule, with no zero bracket amount, no personal exemption (or deduction in lieu of a personal exemption), and no deduction for distributions to beneficiaries.

At its election, however, an estate could compute its taxable income in the same manner as any trust following the death of the grantor. The election, once made, would apply to all subsequent years. Thus, the estate would be entitled to a deduction for distributions or set-asides that carry out DNI, and such distributions or set-asides would be taxable to the beneficiaries. Any amount of an estate's taxable income not distributed or irrevocably set aside currently would be subject to tax at the highest individual marginal rate. For this purpose, set-asides and distributions made within 65 days of the close of the taxable year would be treated as made on the last day of the taxable year. As under present law, distributions or set-asides that are made in satisfaction of a bequest or gift of specific property or a specific sum of money would not carry out DNI, although an estate (or trust) would be entitled to elect to have specific gifts or bequests carry out DNI (with the consent of the

distributee). Appropriate rules would be provided to limit the ability of estates to obtain unintended tax benefits by prolonging their administration.

Effective Date

The proposal would apply to estates of decedents dying on or after January 1, 1986.

Analysis

By placing estates on the same taxable year as the decedent, the proposal would eliminate the selection of a taxable year for an estate that defers the taxation of the estate's income. Moreover, the denial of a distribution deduction would prevent the splitting of income between the estate and its beneficiaries, while permitting estate income to be taxed under a separate rate schedule. In cases in which the absence of a distribution deduction was undesirable, however, the executor could elect to have the estate taxed as if it were a post-death trust.